BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
JAMES A. AND SHEILA L. ORTLOFF)

Appearances:

For Appellants: Charles S. Dixon

For Respondent: Carl G. Knopke
Counsel

O P I N I O N

This appeal is made pursuant to section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of James A. and Sheila L. Ortloff against a proposed assessment of additional personal income tax in the amount of $4,231.19 for the year 1976.

On their joint California personal income tax return for 1976, appellants reported income from interest and other nonfarm sources in the amount of $240,131 and losses from farming activities of $194,103, thereby resulting in a reported adjusted gross income of $46,028; no items of tax preference were reported. On June 30, 1977, appellants filed an amended return reflecting an item of net farm loss tax preference in the amount of $103,986. In arriving at their item of net farm loss tax preference, appellants excluded the interest and taxes paid on their farm land. On January 30, 1978, appellants filed a second amended return incorporating changes resulting from a federal audit. Insofar as pertinent here, appellants decreased their item of net farm loss tax preference by the amount of claimed farm depreciation disallowed by the Internal Revenue Service. Appellants did not, however, adjust their item of net farm loss tax preference to reflect an additional cattle death loss deduction of $1,819 allowed by the federal authorities.

During the year in issue, appellants' farm property was encumbered by mortgages on which they paid $64,211 in interest in 1976; the borrowed funds were used to pay the purchase price of the farm property. Appellants also paid $10,906 in property tax on their farm property.

Upon examination of their return, respondent concluded that appellants had erroneously computed their item of net farm loss tax preference. Specifically, respondent determined that appellants erred in eliminating from that computation the deductions resulting from the aforementioned cattle death loss and the payments of interest and taxes. The subject notice of proposed assessment was subsequently issued reflecting respondent's determination of the resultant increase in appellants' tax liability. Appellants protested respondent's action, arguing that the deductions in issue did not constitute deductions "directly connected with the carrying on of the trade or business of farming" and, therefore, should not be included in the computation of their item of net farm loss tax preference.

Revenue and Taxation Code section 17063, subdivision (i),[1] as it existed for the year in

[1] Hereinafter, all references are to the Revenue and Taxation Code unless otherwise indicated.

issue,[2] included as an item of tax preference "[t]he amount of net farm loss in excess of fifteen thousand dollars ($15,000) which is deducted from nonfarm income." The term "farm net loss" is defined by section 17064.7 as:

> . . . the amount by which the deductions allowed by this part which are directly connected with the carrying on of the trade or business of farming, exceed the gross income derived from such trade or business. (Emphasis added.)

In essence, appellants maintain that the emphasized portion of section 17064.7 is sufficiently restrictive so as to eliminate the subject deductions from the computation of their item of net farm loss tax preference. Those deductions, they assert, were not "directly connected" with the carrying on of the trade or business of farming. The resolution of appellants' argument is the sole issue presented by this appeal.

Former section 17063, subdivision (i), was intended as a replacement for former section 18220. While it changed the method of deterring tax motivated farm loss operations, the focus of the new section, i.e., "farm net loss," remained the same as that of the section it replaced. Except for certain provisions not in issue here, section 17064.7 defines "farm net loss" in a manner identical to that of former section 18220, subdivision (e). Pursuant to respondent's regulation 19253,[3] regulations adopted pursuant to Internal Revenue Code section 1251 (after which former section

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2/ AB 93 (Stats. 1979, Ch. 1168), operative for taxable years beginning on or after January 1, 1979, rewrote subdivision (i) of section 17063 as subdivision (h) and increased the excluded amounts thereunder.

3/ In pertinent part, this regulation provides as follows:

> In the absence of regulations of the Franchise Tax Board and unless otherwise specifically provided, in cases where the Personal Income Tax Law conforms to the Internal Revenue Code, regulations under the Internal Revenue Code shall, insofar as possible, govern the interpretation of conforming state statutes
> . . . .

18220 was patterned) governed the interpretation of the term "farm net loss" under former section 18220, subdivision (e). Given the successor relationship between section 17064.7 and former section 18220, subdivision (e), the Treasury regulations promulgated pursuant to section 1251 of the Internal Revenue Code are applicable for purposes of interpreting the term "farm net loss" as it appears in section 17064.7.

Treasury Regulation § 1.1251-3(b) (1) defines "farm net loss" as follows:

> . . . The term "farm net loss" means the amount by which--
>
> (i) The deductions allowed or allowable for the taxable year by chapter 1 of subtitle A of the Code which are directly connected with the carrying on of the trade or business of farming, exceed
>
> (ii) The gross income derived from such trade or business. (Emphasis added.)

An item which is otherwise deductible by a taxpayer may be deducted from gross income to arrive at adjusted gross income if it is attributable to a trade or business carried on by him other than as an employee. (Int. Rev. Code of 1954, § 62(1).) For the item to be deductible in arriving at adjusted gross income, the connection with the trade or business must be a direct one, If the expense is not incurred in the carrying on or running of the business, the connection is usually considered too remote. (Compare J. T. Dorminey, 26 T.C. 940 (1956) with Ebb James Ford, Jr., 29 T.C. 499 (1957).) Similarly, except for provisions not relevant to this appeal, a taxpayer engaged in the trade or business of farming may deduct from gross income those losses incurred in that trade or business. (Rev. & Tax. Code, § 17206, subd. (c)(l): former Cal. Admin. Code, tit. 18, reg. 17206(f), subd. (l)(A), repealed Feb. 14, 1981.)

Appellants readily acknowledge that they are engaged in the trade or business of farming. As noted above, however, they maintain that the subject deductions resulted from expenses and losses which were too attenuated from that business to be considered "directly connected with the trade or business of farming." After careful consideration of appellants' position and for

the specific reasons set forth below, however, we conclude that appellants' argument is untenable and that respondent properly concluded that the aforementioned farm interest, farm property tax, and cattle death loss deductions were to be included in the computation of appellants' item of net farm loss tax preference.

As noted above, section 62(1) of,the Internal Revenue Code of 1954 (the equivalent of section 17072, subdivision (a)) provides that an expense attributable to a taxpayer's trade or business may be deducted by the taxpayer to arrive at adjusted gross income only if the connection between the expense and the trade or business is direct. In the Appeal of Vincent 0. and Jovita L. Reyes, decided by this board November 16, 1981, we addressed an issue identical to the one presented here, i.e., whether expenses incurred for interest and taxes paid on farm property are "directly connected" with the trade or business of farming. The reasoning adopted in that decision is equally applicable here:

> . . . We believe that appellants' indebtedness, from which the relevant interest deduction resulted, had ... a direct casual relationship with their farming activities. Their use of the loan proceeds to pay for the land on which those activities were conducted ... established that relationship. [Citations.] Similarly, the expense incurred for [property taxes] paid in 1976 also was directly connected with appellants' farm business; the payment of those taxes was directly attributable to the operation and maintenance of appellants' business. [Citations.]

As we noted in the Appeal of Vincent 0. and Jovita L. Reyes, supra, the legislative history behind the enactment of section 62(1) of the Internal Revenue Code of 1954 supports our conclusion that the subject payments of interest and taxes were, directly related to appellants' farming business. Insofar as pertinent here, section 62(1) is the substantive successor of section 22(n)(l) of the Internal Revenue Code of 1939. The legislative history of the latter'reveals that Congress intended that interest and tax payments of the type in issue here would be deductible from a taxpayer's gross income to arrive at adjusted gross income if those expenses were incurred in a taxpayer's trade or business; in such a case, Congress observed, the interest and tax payments would be directly connected with the trade or business carried on by the taxpayer. The House of Representatives Report'states, in pertinent part:

> . . . taxes and interest are deductible in arriving at adjusted gross income only as they constitute expenditures attributable to a trade or business or to property from which rents or royalties are derived. The connection contemplated in this statute is a direct one rather than a remote one. For example, property taxes paid or incurred on real property used in the trade or business would be deductible, . . . (H.R. Rep. No. 1365, 78th Cong., 2d Sess. (1944), [1944 Cum. Bull. 821, 8391). A similar statement is found in S. Rep. No. 385, 78th Cong., 2d Sess. (1944), [1944 Cum. Bull. 858, 8781.

The above quoted material clearly reveals that interest payments on loan proceeds used in a taxpayer's trade or business, as well as taxes paid in connection with the operation or maintenance of that business, are deductible from the taxpayer's gross income to arrive at adjusted gross income since they are expenses directly connected to the trade or business being carried on by the taxpayer. Similarly, we conclude that there existed a direct relationship between appellants' cattle death loss and their farm business. (See, e.g., Wright v. U.S., 15 Am.Fed.TaxR.2d 116 (1965); Logan W. Marshall, ¶ 41,112 P-H Memo. B.T.A., modified without discussion of this point, 128 F.2d 741 (6th Cir. 1942), cert. den., 317 U.S. 657 [87 L.Ed. 528] (1942).) Accordingly, we must conclude that respondent properly determined that the subject deductions were to be included in the calculation of appellants' item of net farm loss tax preference.

Appeal of James A. and Sheila L. Ortloff

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of James A. and Sheila L. Ortloff against a proposed assessment of additional personal income tax in the amount of $4,231.19 for the year 1976, be and the same is hereby sustained.

Done at Sacramento, California, this 1st day of February , 1982, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Reilly, Mr. Dronenburg, and Mr. Nevins present.

William M. Bennett , Chairman

George R. Reilly , Member

Ernest J. Dronenburg, Jr. , Member

Richard Nevins , Member

, Member